# Bankruptcy Contracting Reviewed

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Western bankruptcy systems have two relevant features: (a) The systems are mandatory, that is, parties are required to use the state supplied system; and (b) each system has a number of mandatory rules. Until recently, reformers took these features as givens. The reformers' goal has been to improve the mandatory bankruptcy system and the mandatory rules within it.[1] Some scholars now contest the first relevant feature, arguing that requiring parties always to use one bankruptcy system is inefficient. In a recent essay,[2] I challenged both of these features.

I made these claims:

(A) The only goal of a business bankruptcy law should be to reduce the cost of debt capital, which the law best does by maximizing the debt investors' insolvency state payoff.

(B) Regarding mandatory bankruptcy systems:
  (i) Requiring parties always to use the mandatory state system increases a borrowing firm's cost of capital over the cost that would obtain in a world in which the firm and its creditors could contract for an alternative bankruptcy system.
  (ii) If the rule against contracting for a preferred bankruptcy system were relaxed, parties would write "bankruptcy contracts" that would induce a borrowing firm to choose the system that would be optimal for it and its creditors were it to become insolvent.

(C) There should be few mandatory rules within bankruptcy systems. More precisely, § 365(e) of the Bankruptcy Code,

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1. This focus animated the recent report by the National Bankruptcy Commission. *See* NATIONAL BANKR. REV. COMM'N, BANKRUPTCY: THE NEXT TWENTY YEARS (1997).

2. Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807 (1998).

> which prohibits the use of ipso facto clauses,[3] should be repealed. An analysis of this section also suggests that the wisdom of other mandatory rules should be rethought.

Professor LoPucki's reply[4] to my essay does not challenge claims (A) and (C) and explicitly accepts claim (B)(i). Professor LoPucki attempts to refute claim B(ii), and he makes a new, related claim. Regarding his refutation, I showed formally that parties would write bankruptcy contracts when all creditors (a) lend to the firm at the same time and (b) have the same preferences regarding bankruptcy systems. I then extended this result to argue that (a) parties would write these contracts when creditors lend at different times; and (b) creditor conflict regarding bankruptcy contracts would be rare if courts followed the absolute priority rule, and the few inefficient refusals to sign these contracts would be eliminated were the law to permit the preferences of a majority (in amount) of creditor claims to determine whether a bankruptcy contract became effective. My essay thus predicted that parties would write bankruptcy contracts if they were free to do so and if bankruptcy law were appropriately modified. This prediction is not testable today because bankruptcy contracts are unenforceable.[5] Hence, my essay attempted to motivate reform. If there is a possibility that free contracting over bankruptcy systems would increase welfare, and if there otherwise is nothing wrong with free contracting, then free contracting should be permitted.

Professor LoPucki argues that, even if one accepts the assumptions of my model, strategic behavior by borrowing firms would prevent the writing of bankruptcy contracts when the firm's creditors have the same preferences regarding bankruptcy procedures but lend at different times. He goes on to argue that actual creditors' preferences regarding bankruptcy systems almost always differ, so that creditors could not agree on a bankruptcy contract even if they lent at the same time. Taken together,

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3. 11 U.S.C. § 365(e) (1994). An ipso facto clause authorizes a party to cancel a contract if its contract partner becomes insolvent. When such clauses are illegal, the insolvent party's bankruptcy trustee can accept—that is, keep in force—a contract that the solvent party would prefer to end. My essay set out the intuition underlying the claim that § 365(e) should be repealed. For a more extensive formal treatment, see Yeon-Koo Che & Alan Schwartz, *Section 365, Mandatory Bankruptcy Rules and Inefficient Continuance*, 15 J.L. ECON. & ORG. 441 (1999).

4. Lynn M. LoPucki, *Contract Bankruptcy: A Reply to Alan Schwartz*, 109 YALE L.J. 317 (1999).

5. Professor LoPucki may disagree with the view that bankruptcy contracts are not enforceable, *see id.* at 333, but the authority on whom he relies states: "[C]ourts seem to accept, almost as a matter of faith, that commercial agreements waiving the right to file for bankruptcy are unenforceable," *see id.* at 333 n.96. According to another authority upon whom LoPucki relies, the courts' belief also is shared by bankruptcy practitioners. *See id.* at 334 n.97; *see also* Michael St. Patrick Baxter, *Bankruptcy Proofing: Bankruptcy Provisions in Restructuring Agreements*, 8 J. BANKR. L. & PRAC. 483, 494 (1999) ("Agreements not to file for bankruptcy are *per se* invalid, void as against public policy and in derogation of . . . statutory rights to declare bankruptcy, which cannot be waived.").

these arguments lead Professor LoPucki to conclude that bankruptcy contracts seldom would arise if the prohibition on writing them were reversed.

This conclusion, if true, would be helpfully clarifying but would not count strongly against an argument for greater freedom of contract in the bankruptcy field. If free contracting over bankruptcy systems would be efficient in ideal conditions, then the fact that scholars today cannot plausibly show how real parties would write real contracts is not a serious refutation. The real parties should be given a chance to see how much of the scholar's heaven they can actually enter. Professor LoPucki's new claim responds to this point. In his view, sophisticated parties today exploit current law to write contracts regarding bankruptcy that redistribute wealth to themselves from less sophisticated parties and involuntary creditors such as tort victims. Parties would, he claims, use more freedom to contract to engage in greater redistributional efforts. The relation between Professor LoPucki's new claim and his challenge to my argument is this: If current contracting practices support an inference that parties would abuse a greater right to contract, giving them this right is unwise. A showing that my model does not work thus both serves to defeat my particular claim about bankruptcy contracting and helps to impeach the more general claim that bans on free contracting should be repealed.

I am grateful to Professor LoPucki for giving me the opportunity to clarify certain steps in my argument, but his reply itself is unsuccessful. A disagreement between scholars can take three forms: First, there can be disagreement about the state of the world. In law and economics, this disagreement commonly takes the form of contesting the assumptions that underlie a model. Second, there can be disagreement about the norms that do or should apply to the case under study. Third, there can be disagreement about the analysis. In this third category, the issue is whether a scholar's conclusions follow from his premises. Professor LoPucki's critique takes the third analytic form. He argues that my premises entail less favorable conclusions for bankruptcy contracting than I claim. This critique fails, however, because Professor LoPucki's arguments are either ruled out by my model's plausible assumptions or reflect a misunderstanding of the model. It does not follow that my policy prescriptions must be accepted, because there still can be disagreement over facts or norms. But since Professor LoPucki does not argue about facts or norms, and since my model withstands his analytical critique, we are left where my essay ended. In the absence of a plausible disagreement with my analysis that takes the first or second form, the state should give free contracting a chance.

Part I below refutes Professor LoPucki's criticisms of my model. Part II shows that current contracting practices are irrelevant to the question whether ex ante bankruptcy contracts should be lawful, and thus that these

contracts cannot support an inference that greater freedom to contract about bankruptcy would be harmful. Part III is a conclusion that briefly discusses what may be the basic source of the disagreement between Professor LoPucki and me: that bankruptcy in my view is, and apparently in his view is not, a part of the law of business transactions generally.

## I. BANKRUPTCY CONTRACTING

### A. *When Creditors Lend at Different Times*

#### 1. *A Summary of the Model*

My model assumed that two bankruptcy systems existed. One system, denoted *L*, resembled the current Chapter 7, and the other, denoted *R*, resembled the current Chapter 11. For the purposes of this Response, the parties in my model could write two types of bankruptcy contracts. The first would not deal explicitly with bankruptcy at all, leaving the insolvent firm free to choose the bankruptcy system it preferred ex post. Since creditors are legally entitled to the full monetary return from a bankruptcy procedure, the firm would not consider this return in making its choice. Rather, the firm's owners/managers[6] would choose the bankruptcy system that maximized their private benefits. The parties, however, could renegotiate after insolvency to induce the firm to choose the bankruptcy system that generated the highest monetary return when that system did not also maximize the firm's private benefits. The model assumed that a firm always gets greater private benefits in the reorganization system *R* because the managers get to run the firm for a longer time in that system and also have some chance of saving the business. Hence, the parties would renegotiate only when the liquidation system *L* turned out to generate a higher monetary return than the reorganization system *R*. The creditors then would pay the firm a sum to forgo the *R* system's greater private benefits and instead enter liquidation.

The second contract I discussed—and the one Professor LoPucki considers—authorized the firm to keep a portion of the monetary return that would be generated by whatever bankruptcy system it chose. If this portion—the "bribe"—were set appropriately, the sum of the private benefits and cash payments the firm would get if it chose the optimal

6. My analysis focused on the firm's relationship with its debt investors, not the relationship between the firm's managers and its equity investors. This focus was captured formally by assuming that the firm's shareholders and managers had the same preferences regarding bankruptcy procedures. The assumption often is realistic in the bankruptcy context because the shareholders and managers both commonly prefer the insolvent firm to be continued rather than liquidated.

system always would exceed the firm's total payoff from choosing suboptimally. This contract was called renegotiation-proof because the parties would have no need to renegotiate later: The firm would choose the efficient bankruptcy system if the contract bribe was correctly specified.

One or the other of these contracts would maximize the creditors' insolvency-state payoff and thereby minimize the firm's cost of capital, depending on the relevant economic parameters. For example, the renegotiation contract would often be best when the reorganization system had a higher expected return than the liquidation system. The creditors do not pay a bribe under this contract and thus could keep the entire high return that system $R$ would generate; the firm would choose $R$ without a bribe because it would get greater private benefits in that system. If the liquidation system generated the higher expected return, on the other hand, the renegotiation-proof contract often would be best. The firm then would have to be bribed to choose liquidation. The ex post bribe would exceed the contractual bribe because ex post it is known with certainty that the firm will choose the inefficient system; hence, the firm could exploit its bargaining power to capture most of the monetary gain from choosing optimally. Though one or the other of these contracts can be efficient, depending on the economic parameters, only renegotiation contracts can be written under current law. This restriction thus reduces welfare.

My model assumed that creditors could observe and verify to a court the actual monetary return that a bankruptcy procedure would generate. Thus, if the lending agreements promised the firm, say, 30% of the monetary return from bankruptcy, the creditors could recover the remaining 70% in a bankruptcy proceeding. The creditors, however, could not verify to a court, and might be unable to observe, all of the firm's private benefits. This would not preclude bankruptcy-contracting, because the firm offers creditors the bankruptcy contract, and it knows what its private benefits would be; hence, it could select the contract—renegotiation or renegotiation-proof—that would maximize the creditors' insolvency-state return (and thereby lower the firm's capital costs). Creditors would sign whatever contract the firm offered because, in a competitive credit market, creditors earn zero profits in all equilibria and so would be indifferent to the contract the firm chose; the interest rate would reflect the effect of that contract.

A renegotiation-proof contract would have to be modified in those cases in which the creditors lent at different times because the optimal bribe could change with changes in the relevant economic parameters. The contract thus would need a conversion term, such that if the optimal bribe later changed, the bribes in all prior contracts would be updated to equal the newly optimal bribe: the portion of the bankruptcy return from whatever system the insolvent firm chose that would be sufficient to induce the firm

to choose optimally. The initial creditor would sign a contract in which the bribe could change because the contractual bribe would not change in expectation.[7]

2. *Professor LoPucki's Reply*

Professor LoPucki argues that the borrowing firm would exploit this scheme in such a way as to cause the first lender not to sign. This would unravel the scheme. To understand his claim, assume that when the firm first borrows, it expects to borrow again, and the optimal bribe would give the firm one-third of the monetary return from the bankruptcy system it chose. This bribe is a function of the economic parameters the firm expects would exist if it became insolvent. In an efficient market, the current parameters are the best estimate of the future parameters. The firm thus would believe, when it initially borrows, that a one-third bribe also will be optimal when it borrows again. The firm, however, would not offer the initial creditor a contract in which it agreed to choose the optimal bankruptcy system in return for a bribe of one-third the bankruptcy return. Rather, in Professor LoPucki's scheme, the firm would ask only for a bribe of one-fourth that return. Since the initial creditor could keep 75% of the bankruptcy return under this contract, the interest rate would be lower than it would have been under the correct contract, which would pay the creditor only two-thirds of the return. The firm would offer the incorrect contract to the initial creditor because it knows that when it borrows again, it will require the optimal one-third bribe in the later contract, and the first contract will automatically convert to a one-third bribe as well. As a consequence, the firm's full set of bankruptcy contracts would be consistent and correct, but the first creditor would have been deceived into charging an interest rate that is too low.[8]

The first creditor, however, would anticipate this deceitful behavior and not lend. Nor could the borrowing firm overcome this reluctance because it cannot make a credible commitment not to exploit the creditor in this way. The optimal bribe is a function of the monetary returns and private benefits that bankruptcy makes possible. Thus, if the firm later raised the bribe percentage, the initial creditor could not sue to recover the interest payments it erroneously gave up because the creditor could not establish the

7. In an efficient market, the best estimate of the economic parameters that will obtain tomorrow is the parameters that obtain today. This is because, in the absence of a reason to believe otherwise, a party will know that the parameters are as likely to increase as decrease; hence, the expected value of these changes is zero. If there were a reason to believe otherwise, then today's parameters would reflect this reason.

8. Professor LoPucki states: "[T]he firm could at least sometimes deceive the initial creditor as to the optimal [bribe] percentage. If the firm succeeded in its deception, the firm would be able to borrow on more favorable terms." LoPucki, *supra* note 4, at 325.

value of the private benefits in court and so could not prove that the firm set the initial bribe at an artificially low level.

Professor LoPucki claims that this result is consistent with my model's assumptions and refutes my conclusions. There are at least two difficulties with this position. First, Professor LoPucki's scheme is ruled out by the assumption that parties in my model cannot commit fraud. Second, if fraud were permitted, the desire of most firms to preserve good will would prevent them from engaging in Professor LoPucki's scheme. Regarding the first, the borrowing firm would be engaged in a fraud because it represented to the initial creditor that a bribe of one-fourth the monetary return would induce the firm to choose the optimal bankruptcy system when the firm *knew at the time it offered the contract* that a bribe of one-third that return would be necessary. Put another way, the firm intended not to perform its contractual promise to choose the optimal bankruptcy system in return for a payment of only one-fourth the bankruptcy return. A contractual promise that is made with the present intention not to perform is a fraudulent representation.[9]

Contract-theory models assume that parties will not engage in fraud.[10] This is because fraud will undo any contracting scheme, however simple. A possible buyer thus would not purchase if he believed that the seller had a present intention to substitute inferior goods for the contract goods after the buyer paid, or a present intention not to honor the contract's repair and replacement warranty. Consistent with this view, the Uniform Commercial

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9. Section 530(1) of the *Restatement (Second) of Torts* states that "[a] representation of the maker's own intention to do or not to do a particular thing is fraudulent if he does not have that intention." RESTATEMENT (SECOND) OF TORTS § 530(1) (1977). Comment c to this provision states:

> The rule stated in this Section finds common application when the maker misrepresents his intention to perform an agreement made with the recipient. The intention to perform the agreement may be expressed but it is normally merely to be implied from the making of the agreement. Since a promise necessarily carries with it the implied assertion of an intention to perform it follows that a promise made without such an intention is fraudulent and actionable in deceit under the rule stated in § 525.

*Id.* cmt. c.

10. This assumption is made so often as generally to go without saying, but I can offer a few examples. The first is from a famous early article, Sanford J. Grossman, *The Informational Role of Warranties and Private Disclosure About Product Quality*, 24 J.L. & ECON. 461 (1981). Professor Grossman began his analysis of the warranty contracts that sellers would offer with the statement "We restrict attention to [seller] disclosures which are truthful." *Id.* at 464. He went on to give an example that was meant to show that buyers would make inferences about product quality or quantity that are unfavorable to the seller when the seller is permitted to be silent or vague but cannot lie. The example starts with these sentences: "Suppose the monopolist is selling boxes of apples. He can label the boxes with an exact number of apples, but if he does this then this must be the true amount under the above 'no lying' assumptions. However, he could also put no label as to the quantity . . . ." *Id.* at 465. A second example is from a recent paper that prefaced its analysis of what a good disclosure law would look like with the clarification: "Fraudulent disclosures are not considered." Michael J. Fishman & Kathleen M. Hagerty, Mandatory vs. Voluntary Disclosure in Markets with Informed and Uninformed Consumers 7 (Aug. 1999) (unpublished manuscript, on file with *The Yale Law Journal*).

Code does not cover fraud, but rather regulates warranties and repair-and-replacement promises under the assumption that sellers intend to honor their contractual obligations when they sign agreements.[11] Scholars and decisionmakers thus assume that the law of torts will deter those frauds that reputational considerations alone will not prevent, and they suppose that transactional law will regulate deals among honest people. Consequently, the task for contract theory is to ask what agreements parties will make when they cannot lie to each other at the contracting stage. My model was in that genre, and it is not embarrassed by showing that parties would reject the contracts I identify if they could engage in fraudulent schemes. Many more contracts than mine would be undone under that dispensation.[12]

In addition, business borrowers would be unlikely to commit the fraud Professor LoPucki imagines because, like many only imaginable frauds, the good-will costs would be too high. The optimal bribe is a function of the relative monetary returns that the two bankruptcy systems are expected to generate and the private benefits that the firm can realize under either system. If the liquidation system would generate high returns relative to the reorganization system, for example, the bribe could be lower. The firm gives up private benefits in return for a cash payment, and when the total return is high, a cash payment that is a smaller portion of that return will suffice. The bribe also could be lower if the private benefits that the two systems permit do not differ by very much.

The firm, in Professor LoPucki's scheme, would have to tell the initial creditor that the bankruptcy bribe it might later have to pay had been raised.[13] At the time of the initial loan—denoted $t^0$—a firm bent on fraud thus knows that it later will need a justificatory story: It raised the requisite bribe because the relation between the expected monetary returns the two bankruptcy systems will generate has changed, or the relative private benefits have changed (or both). The firm would not expect the relative

11. Section 1-103 of the Uniform Commercial Code states that "[u]nless displaced by particular provisions of this Act, . . . the law relative to . . . estoppel, fraud, misrepresentation . . . bankruptcy, or other validating or invalidating cause shall supplement its provisions." U.C.C. § 1-103 (1993).

12. The bankruptcy contracts I consider are similar to most-favored-nation clauses in long-term sales contracts. In these contracts, the seller agrees with the initial buyer that if the seller offers better pricing terms to later buyers, the original contract will convert to the new terms. A seller with market power could plan to defraud the original buyer by setting the original price at an artificially high level, retaining this price in the later contracts it knows it will make, but offering later buyers favorable non-price terms—such as prompt post-sale service—that are difficult for the initial buyer to observe. In this way, the later buyers would get the deals that current conditions warrant, while the initial buyer would always pay the excessive price. An early buyer who anticipated this behavior might not agree to the contract. Despite this possibility, most-favored-nation clauses are widely used, and scholars have examined their properties on the (implicit) assumption that parties to them do not routinely commit fraud.

13. A lending agreement would require this updating notice to permit the initial creditor to calculate the current value of its loan. That value is partly a function of the creditor's expected insolvency state return.

monetary returns to change because expected returns at time $t^0$ are the best predictor of the expected bankruptcy returns. My model also assumed that creditors could observe the expected monetary returns from the two systems.[14] The firm thus would know at $t^0$ that it would later have to justify raising the bribe percentage—that is, lowering the initial creditor's bankruptcy return—on the ground that the private benefits the firm expects to realize in bankruptcy had changed between the time of the first and second loans.[15]

The good-will cost of conveying this justification would be substantial. An initial creditor who could not observe the private benefits that the firm would realize in bankruptcy would draw one of two inferences when the firm raised the required bribe because of alleged changes in these benefits: (a) The firm lied when it said it needed only one-fourth of the bankruptcy financial return in order not to dissipate the creditor's bankruptcy claim in an inefficient reorganization; that is, *the firm knew all along* that it needed a one-third bribe to behave fairly toward the creditor; or (b) the firm has come to realize that it needs a higher bribe not to waste the creditor's assets in a suboptimal procedure than the firm initially thought it needed.[16] Turning to good-will costs, assume for simplicity that when the firm borrows again (and thus raises the initial bribe) its prospects are either bad or good. If bad, the firm knows that it may need the initial creditor's cooperation in a workout or a bankruptcy proceeding. A creditor who thinks it has been defrauded is less likely to cooperate. If the firm's prospects are good, it expects to have a continuing need for credit. The initial creditor

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14. See equations (4) and (5) in Alan Schwartz, *Contracting About Bankruptcy*, 13 J.L. ECON. & ORG. 127, 135-36 (1997), which set out the formal model from which my essay draws. These returns are also terms in my essay's $E(R)$ equations. *See* Schwartz, *supra* note 2, at 1829-30.

15. For readers who are helped by equations, recall from my earlier essay that the optimal bribe $s^*$ is

$$s^* = \frac{b_{LR} - b_{LL}}{y_{LL} - y_{LR}}.$$

I assumed that creditors could observe the denominator—the difference between the expected monetary return in an optimal procedure $L$ and in a suboptimal procedure $R$. The initial creditor thus would know that the denominator had not changed. Hence, the firm would have to claim that the optimal bribe fraction $s^*$ had risen because the numerator had changed: That is, the difference between the private benefits the firm would receive in a suboptimal procedure $R$ and in an optimal procedure $L$ had widened.

16. My model assumed for convenience that the initial creditor could not verify and might not be able to observe private benefits at all, but this creditor likely can observe some elements of these benefits, such as the salaries that the debtor's managers get. Partial observability strengthens the argument made above. For example, if the firm raised the required bribe after unexpectedly increasing the managers' salaries, the initial creditor would believe it was being exploited. And if the firm raised the bribe though no observable elements of the private benefit variable had changed, this would make more plausible a creditor inference that the firm had lied when it specified the original bribe.

then could be a source of funds or a credit reference. It would not perform either task as the firm might wish, however, if it thought that it had been defrauded. The firm thus would be reluctant to raise the bribe in the initial lending agreement, and thereby convey a bad message to the initial lender, unless the observable monetary parameters actually had changed. Hence, the firms in my model would be reluctant to use Professor LoPucki's scheme even if fraud were permitted. An initial creditor would know this and thus would sign a bankruptcy contract.

### B. *Creditor Conflict*

A creditor who refuses to sign a contract that would offer the firm a bribe to choose the optimal bankruptcy system—the renegotiation-proof contract—would have the right, in a bankruptcy, to claim the full value of its unpaid debt, undiminished by the bribe the other creditors had agreed to pay. If too many creditors refused to sign, the firm would anticipate that too small a fraction of the bankrupt estate would remain after satisfying the nonsigners to pay the firm the requisite bribe. As a consequence, the contractual scheme would fail. Professor LoPucki believes that failure would be common because creditor conflict is pervasive. This Response will show (as my essay originally showed) that while junior and trade creditors could in theory have incentives not to sign bankruptcy contracts, they would not have these incentives in fact if bankruptcy law were appropriately enforced and amended.

#### 1. *Junior and Senior Conflict*

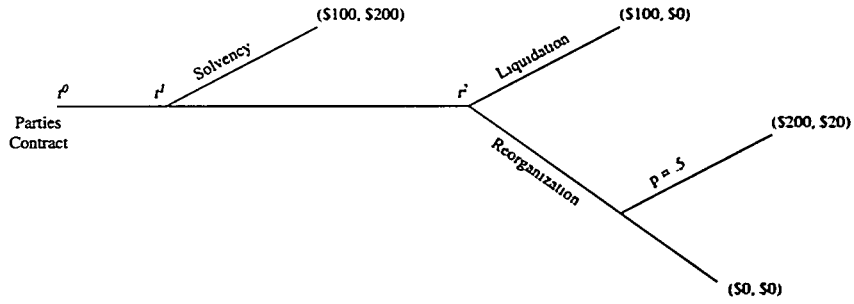
Under bankruptcy schemes that respect absolute priority, a junior creditor is paid only after creditors senior to it have been paid in full. Therefore, junior creditors would like the bankruptcy pie to be as large as possible because this increases the chance that there will be something left over. The seniors also would like the pie to be maximized; thus, both juniors and seniors want the firm to choose the bankruptcy procedure that maximizes the insolvency-state monetary return. Professor LoPucki responds that junior creditors would prefer reorganization to liquidation even when liquidation would generate a higher monetary return, if the variance of returns in a reorganization would sufficiently exceed the variance in a liquidation. Under this condition, the juniors' bankruptcy claim would have a higher expected value in a low-return reorganization than the claim would have in a higher-return liquidation.

Professor LoPucki believes that variance-induced junior/senior conflict "is the norm"[17] in bankruptcy contexts. This view encounters three difficulties: First, as just noted, I assumed that courts would follow the absolute priority rule while Professor LoPucki, we will see, assumes that courts will violate the rule. Junior/senior conflict will vanish if courts follow absolute priority. Second, even if courts misapply the rule, the juniors and seniors commonly would agree on a bankruptcy contract. And third, when they disagreed, conflict among them would be eliminated by contract.

a. *The Relevance of Absolute Priority*

The first difficulty is best illustrated by example. At $t^0$, the firm borrows $100 from senior creditors and $200 from junior creditors.[18] At $t^1$, the firm realizes returns and either pays its debts if solvent, or enters bankruptcy if insolvent. At $t^2$, the firm exits bankruptcy, either in reorganized form or via a liquidation. If the firm is reorganized, it will be worth $220 with probability .5 and $0 with probability .5, and so would have a value of $110 (.5 × $220 + .5 × $0 = $110). Assume for tractability that the firm would be worth $100 in a liquidation with certainty. The example is set out in Figure 1, in which the parties' payoffs are in parentheses with the senior claimants' payoff given first.

FIGURE 1




The firm should be reorganized because its going concern value of $110 exceeds its liquidation value of $100. Section 1129(b)(1) of the Bankruptcy Code provides that a court cannot confirm a reorganization plan unless the plan complies with § 1129(a) and also "does not discriminate unfairly, and is fair and equitable" to dissenting creditor classes. Section

17. LoPucki, *supra* note 4, at 329.
18. The seniors could hold security or the juniors could have purchased subordinated debt.

1129(a)(7)(A)(ii) uses the absolute priority rule to put a floor under reorganization bargaining. A creditor class that rejects a plan must "receive or retain under the plan on account of [its] claim . . . property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date."[19] These rules require the senior claimants in this example to receive an equity or debt interest in the reorganized firm at time $t^2$ that would return $200 to them if the firm were successful. The seniors would then hold "property of a value" as of the date of receipt that would be worth $100 (.5 × $200 + .5 × $0 = $100). This sum equals the face value of their debt and also is "not less than" what the seniors would have received "if the debtor were liquidated under chapter 7 . . . on such date." Figure 1 thus gives the seniors a payoff of $200 if the reorganization is successful.

Absolute priority would be violated if the seniors were to receive an interest in the reorganized firm that was worth only $100 in the event of success. In such a case, the seniors would have received property in liquidation that was worth $100, but would receive property in reorganization that was worth only $50 (.5 × $100 + .5 × $0 = $50). The value of the juniors' claim, conversely, would be $0 in liquidation, but would be $60 in reorganization (.5 × $120 + .5 × $0 = $60). The seniors thus would have been paid in full had a court ordered liquidation, but would be giving up $50 in expected value to the juniors in a reorganization. This would violate absolute priority.[20]

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19. 11 U.S.C. § 1129(a)(7)(A)(ii) (1994).

20. The analysis in the text reflects the only plausible reading of the quoted Bankruptcy Code sections, and there is closely analogous Supreme Court authority as well. In *Dewsnup v. Timm*, 502 U.S. 410 (1992), the Court recognized the need to give a secured creditor the upside return to avoid reducing the value of its claim. To understand the issue in *Dewsnup*, assume that, at the beginning of a bankruptcy, a secured creditor had a lien on property with a then-market value of $200. This value would be a weighted average of the values that could later obtain when the creditor had a right to foreclose (or was awarded the financial equivalent of that right). To facilitate discussion, assume that there is a one-third chance of the property being worth as much as $300 at the end of the bankruptcy procedure; a one-third chance that it will be worth $200; and a one-third chance that it will be worth $100. A junior creditor seeks to "strip the lien," under Bankruptcy Code § 506(d). Were a bankruptcy court to agree, the senior's claim in bankruptcy would be frozen at its current market value of $200, and the junior would receive $100 if the property later increased in value to $300. Stripping the lien, however, would reduce the value of the secured creditor's bankruptcy claim. It would then hold a lien worth $166.33 ($^2/_3$ × $200 + $^1/_3$ × $100 = $166.33); for the creditor would get $200 whether the property turned out to be worth $300 or $200, and would get $100 in the remaining possible case. Put another way, the secured creditor could have recovered $200 if it were allowed to foreclose, but instead it is holding a lien that has a present value of $166.33. The Supreme Court refused to allow the lien to be stripped in this fashion, thereby ensuring that the secured creditor's bankruptcy claim equaled, on an expected basis, the current market value of the property. *See id.* Commentators criticized this result as a matter of statutory construction but approved of it as a matter of policy. *See, e.g.*, ROBERT L. JORDAN ET AL., BANKRUPTCY 133 (5th ed. 1999); JAMES J. WHITE & RAYMOND T. NIMMER, BANKRUPTCY CASES AND MATERIALS 443 n.2 (3d ed. 1996). For theoretical treatments of the issue, see Barry E. Adler, *Creditor Rights After* Johnson *and* Dewsnup, 10 BANKR. DEV. J.

Professor LoPucki's claim that junior/senior conflict over bankruptcy contracts would be pervasive rests on the mistaken belief that a bankruptcy court following absolute priority would award the seniors in the example here an interest in the reorganized firm that would trade for only $50. This can be seen by referring to the example in his essay[21] in which the firm owed $100 to the seniors, $200 to the juniors, would return $100 in liquidation with certainty, and would be worth $200 with probability .4 and zero with probability .6 if the firm were reorganized. The juniors would receive nothing if the firm were liquidated. Professor LoPucki assumed that both juniors and seniors would receive $100 if the firm turned out to be successful. The value of the juniors' interest in the reorganized firm would then be $40 (.4 × $100 + .6 × $0 = $40), and the juniors would prefer reorganization to liquidation. The value of the reorganization interest the seniors would receive, however, would also be worth $40. This would be less than the face value of their debt and less than what the seniors would have received "if the debtor were liquidated under Chapter 7." Hence, Professor LoPucki's example rests on the implicit assumption that bankruptcy courts do not follow absolute priority.

My essay assumed that courts would correctly apply the absolute priority rule (and that parties would know the law). On these assumptions, junior creditors would expect to receive value in a reorganization only after the seniors were awarded an interest in the reorganized firm that would trade in the market on the plan's confirmation date for an amount no greater than the face value of the seniors' debt and no less than the value the seniors would have received had the firm been liquidated. To satisfy these requirements would require the seniors in Professor LoPucki's example and in mine to receive property that would return $200 if the reorganized firm succeeded. The juniors in both of these examples thus would expect to receive nothing in a reorganization and so would have no reason to prefer one bankruptcy procedure to the other. Consequently, the juniors would have no reason to obstruct a bankruptcy contracting scheme. Put more generally, ex ante junior/senior conflict between liquidation and reorganization would largely vanish if bankruptcy courts followed absolute priority.

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1 (1993-1994); Douglas G. Baird & Thomas H. Jackson, *Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy*, 51 U. CHI. L. REV. 97 (1984). Regarding the example in the text, if the insolvent firm has an expected value of $110, a court would preserve the value of the seniors' claim (which often will result from holding security) by giving the seniors an interest in the reorganized firm that would return $200 if the firm were successful. This interest would have a value of $100 on an expected basis.

21. *See* LoPucki, *supra* note 4, at 327-28.

b. *The Unlikelihood of Conflict*

Professor LoPucki's claim of conflict would be unpersuasive (though not ruled out by assumption) if courts were assumed not to follow absolute priority. Such courts would award the juniors a $50 interest in the reorganized firm in Professor LoPucki's example.[22] This example requires clarification before it can be analyzed. Professor LoPucki introduces the example with the sentence, "At the time it must choose between liquidation and reorganization [$t^1$], the firm owes $100 to senior creditors and $200 to junior creditors."[23] This is the wrong time. The issue is whether conflicts will exist among creditors at the contracting stage, not after Humpty Dumpty has fallen from the wall.

Regarding the ex ante case, a junior creditor will know, at the contracting stage, that if too few other creditors sign the firm's renegotiation-proof contract, the contractual scheme will fail whether the illustrative creditor signs or not. The junior also will know that if enough other creditors sign the renegotiation-proof contract, the scheme will come into existence regardless of what it does. The junior's agreement will count only when it is "pivotal"—only when its assent would save the contracting scheme and its dissent would kill it.

To see what the junior will do (in a world in which absolute priority is not followed), realize that junior creditors have a call option on the insolvent firm: They can buy the firm from the seniors by paying the seniors' claims. A pivotal junior thus will refuse to sign the renegotiation-proof bankruptcy contract when its call option would be more valuable if the firm has freedom to choose a suboptimal bankruptcy system ex post than if the firm has been bribed contractually to choose optimally. To put this choice a little more precisely, denote the value of the junior's call option if a renegotiation-proof bankruptcy contract exists as $X_o$. Then

$$X_o = p_L \text{ (value of call for optimal } L) + (1 - p_L) \text{ (value of call for optimal } R). \quad (1)$$

Here, $p_L$ is the probability that the liquidation procedure $L$ will be optimal, and $(1 - p_L)$ is the probability that the reorganization procedure $R$ will be optimal.

If there is no renegotiation-proof contract, assume that the firm will choose procedure $R$ whether $R$ is efficient or not (and the court will not follow absolute priority). Denote the value of the junior's call option in this circumstance as $X_{so}$. Then

22. The statements in my essay relating to the juniors' possible preference for low return but high variance reorganizations referred to this case.

23. LoPucki, *supra* note 4, at 327.

$$X_{so} = p_L \text{ (value of call for suboptimal } R) + (1 - p_L) \text{ (value of call for optimal } R). \quad (2)$$

When procedure $R$ would be optimal, with probability $(1 - p_L)$, the firm will choose it without a renegotiation-proof bankruptcy contract, but when procedure $L$ would be optimal, with probability $p_L$, the firm nevertheless will choose procedure $R$. Both juniors and seniors would prefer there to be no contract if the firm chose $R$ whenever $R$ turned out to be optimal, because then the creditors' payoffs would not be diminished by a bribe. Thus, the juniors and seniors would be in conflict when the first term of equation (2) exceeded the first term of equation (1): A call option on the firm in the bankruptcy system with the lower return would be more valuable than a call option on the firm in the system with the higher return.

The value of a call option increases with (i) the ratio of the asset price (here, the expected value of the firm if insolvent) to the exercise price (here, the face value of the unpaid senior debt); (ii) the option's time to maturity multiplied by the market interest rate; and (iii) the variance of the per period return multiplied by the number of periods until maturity. The parties cannot affect the market interest rate or the number of periods until the firm becomes insolvent—factor (ii). Junior/senior conflict at the contracting stage thus would be "the norm" if the value-increasing effect of greater variance—factor (iii)—commonly outweighed in bankruptcy contexts the value decreasing effect of a lower ratio of asset to exercise price—factor (i).

The variance effect would have to be very strong for this conflict to occur routinely. To see why, consider a simple example in which, when the parties contract, the firm is expected to be worth $100 if it later is liquidated in an optimal procedure. The $100 value could vary between the time of the credit extension and the time of insolvency. For simplicity, let this time be one year and suppose that the firm later could take only two values: The firm when insolvent could be worth 20% more than its current expected value—the firm would then be worth $120—or it could be worth 80% of its current expected value, which would be $80. The senior debt is expected to be $100; the junior debt also is $100 and the interest rate is 10% a year. The juniors' call option to purchase the firm for $100 thus is "on the money," and its value is $13.64.[24] Next let the firm be worth $70 in procedure $R$

24. To calculate the (approximate) value of a call option, realize that the value of the option is equivalent to an investment in the underlying asset and borrowing. Regarding the investment strategy, let an investor buy one-half the firm at its expected insolvency value of $100 and borrow $36.36. The cost of purchasing this "portfolio" would be $50 – $36.36 = $13.64. If the firm rose in value to $120, one-half the firm would be worth $60, but the investor must pay the loan off, and at a 10% interest rate this would cost him $40 ($36.36 × 1.1 = $40). Hence, his payoff would be $20. If the firm fell in value to $80, one-half the firm would be worth $40, but again the investor would have to repay $40 and so would earn nothing. If the investor instead bought a call option on

(when it would be worth $100 in the optimal procedure *L*). The reorganization value too could vary with time. Assume that the firm later could take on only two values: (i) it could increase in value to be worth $130, or (ii) it could decrease in value to be worth $40. The juniors' call option in this case would be worth $11.23. The juniors thus would prefer the same renegotiation-proof contract that the seniors prefer because the value of the juniors' call option would be greater if the firm always chose the optimal bankruptcy procedure when insolvent.

In this example, the juniors would receive $30 if reorganization succeeded ($130 less the seniors' $100 claim) and $20 if liquidation succeeded ($120 – $100). The juniors nevertheless would prefer a bankruptcy contract that would induce the firm to liquidate. A more relevant way to put this result is to note that the liquidation value of the firm could increase by 20% (from $100 to $120) while the reorganization value could increase by 86% (from $70 to $130). Thus, junior creditors in the example would have the same contractual preference as the seniors even though reorganization value was more than four times more volatile than liquidation value. Option theory also indicates that Professor LoPucki's ex post example is extreme. In that example, the high-value procedure *L* had zero variance; the firm would be worth $100 in this procedure with certainty. The firm had an expected value of $80 in procedure *R* with positive variance; it could increase in value to $200. Since the low-value *R* procedure in his example had positive variance while the high-value *L* procedure had zero variance, mathematically the low-value *R* procedure was infinitely more varied than the high-value *L* procedure. If absolute priority is not followed, junior creditors would prefer the procedure that had

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the firm, he would earn $20 if the firm rose in value to $120 (recall that the exercise price is $100) but would earn nothing if the firm fell in value to $80 (because he would not exercise the option). Since the payoffs from buying the call option and from buying one-half the firm and borrowing are the same, the cost of these alternatives (in an efficient market) must be the same. Therefore, the call option would have a value of $13.64. The investor would know he should buy one-half the firm by calculating the "option delta," which reflects the sensitivity of the call price to changes in the underlying asset price. The delta here is

$$\Delta = \frac{\textit{spread of possible option prices}}{\textit{spread of possible asset prices}} = \frac{20 - 0}{120 - 80} = \frac{1}{2}.$$

The amount of the required loan *L* is given by solving

$$L = \frac{\Delta Su - Cu}{r},$$

where $\Delta$ is the option delta, *Su* is the high value of the asset, *Cu* is the payoff from the option when the asset increases in value, and r is the interest rate. The other option value that follows in the paragraph in text is calculated similarly. For a review of this simplified method for computing approximate option value, see RICHARD A. BREALEY & STUART C. MYERS, PRINCIPLES OF CORPORATE FINANCE 568-77 (5th ed. 1996).

infinitely more variance, but the condition that one bankruptcy procedure is infinitely more varied than the other seldom would be satisfied in practice. In sum, unless there is good reason to believe that reorganization returns are orders of magnitude more volatile than liquidation returns, junior/senior conflict is unlikely to be "the norm" even if courts fail to follow absolute priority.

c. *The Contractual Solution*

If dissenting junior creditors were to kill an optimal bankruptcy contract, the financial losses they would impose on the seniors would exceed the juniors' financial gain. This is why the contract the juniors prefer is suboptimal. The firm, however, could realize some of the net gain from an efficient bankruptcy contract by offering it and using the gains from the desirable terms the seniors would grant to purchase the juniors' consent.[25] Professor LoPucki acknowledges that this Pareto-improving deal is possible in theory, but he claims that the deal would not occur because the juniors and seniors do not deal with each other.[26] This claim overlooks the ability of the firm to bargain with all of its creditors, and thus to offer a set of contracts to them that would exploit the efficiency gains from an optimal choice of a bankruptcy system.[27] Professor LoPucki actually concedes that the firm can coordinate bankruptcy bargains among creditors who "never negotiate with one another" because he accepts the result of my model that a firm's bankruptcy contracts would be efficient regarding my assumptions that creditors lend at the same time and have the same preferences over bankruptcy procedures. The creditors that I posited dealt with the firm, not with each other.

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25. Some readers may find the argument in text to be clarified by a formal statement. Assume that procedure $L$ would generate a higher value for the insolvent firm than procedure $R$. The difference in value between the two procedures is denoted $v_L - v_R = z$. The junior creditors, suppose, would do better with the firm in reorganization (if the court did not follow absolute priority). Let the juniors' incremental gain from reorganization be $x$. Assume that the senior creditors hold $\lambda$ of the firm's debt and the junior creditors hold $1 - \lambda$. Social welfare in procedure $L$ is the sum of the parties' gains from using the value-increasing procedure less the junior creditors' loss: $W_L = \lambda z + (1 - \lambda) z - x = z - x$. If $L$ is efficient, as is assumed, then $W_L > 0$ because $z > x$. In a competitive credit market, the firm realizes the surplus that its lending agreements create. As just shown, the surplus from an efficient set of bankruptcy contracts is $W_L$. The firm could capture a portion of this surplus by sweetening the terms of its junior debt in return for that debt's agreement to sign an optimal bankruptcy contract.

26. His essay states: "[T]he conflict between junior and senior creditors would be resolved by a contract between them that maximized the value of the estate and divided the increase in value thus attained between them in such a manner that each would be better off. . . . [This contract will not be made because] creditors . . . have no means of bribing one another because they never negotiate with one another." LoPucki, *supra* note 4, at 329-30.

27. The ability of a firm to coordinate its lending agreements to achieve efficiency has been recognized previously. *See* Barry E. Adler, *Financial and Political Theories of American Corporate Bankruptcy*, 45 STAN. L. REV. 311, 313-15 (1993); Alan Schwartz, *A Theory of Loan Priorities*, 18 J. LEGAL STUD. 209, 210-11 (1989).

To summarize, junior/senior conflict would not occur if courts followed absolute priority, is unlikely to occur if they do not, and will not prevent bankruptcy contracting when it does occur.

2. *Trade and Financial Creditor Conflict*

Financial creditors and trade creditors both would like to be repaid, but trade creditors sometimes also would prefer to continue dealing with the insolvent firm. This preference would be strong when the creditor had made a firm-specific investment in the relationship; then the creditor would be earning rents. Such a creditor might be purchasing a specialized input from the insolvent firm or have partially specialized its sales force to deal with the firm. When the trade creditor would expect to do better continuing the firm in existence for a time in a value-decreasing reorganization than it would do collecting its share of the higher liquidation return on its pre-bankruptcy debt, the creditor would refuse to sign the renegotiation-proof contract. That contract would induce the firm to choose the more rapid procedure *L* whenever *L* would generate a sufficiently high monetary return.

My essay made two points about this conflict. First, it is difficult to say how often trade creditors would have the incentive and the power to block a bankruptcy-contracting scheme. Second, whatever power the trade creditors have would be eliminated if the law also were amended to provide that the scheme would become effective if a majority in amount of the debt signed the contract. Under this reform, the contractual scheme would govern unless a majority in amount of the debt was held by trade creditors who expected later to do better sacrificing a portion of their bankruptcy claims in return for continuing the insolvent firm in procedure *R*. The prevailing assumption is that while insolvent firms often have more trade than financial creditors, the financial creditors commonly hold the largest portion of the firm's debt.[28]

Moreover, a majoritarian trade-creditor preference for the renegotiation contract (in which the firm is not contractually bribed to choose the optimal system) would prevail only when a renegotiation-proof contract would be

28. Professor LoPucki raised several objections to this majority-rule proposal. *See* LoPucki, *supra* note 4, at 330. First, it was unclear how the majority should be counted. As just noted, the proposal was to permit the preferences of a majority in amount of the firm's debt to control. Second, the proposal was inconsistent with the conversion term discussed above, which would alter the bribe percentages in earlier contracts to the percentage in the firm's latest contract. It is unclear why he thinks that an inconsistency would exist. Suppose, for example, that a majority (in amount) of creditors sign the firm's renegotiation-proof contract. If the law were to provide that the preferences of a majority would control as regards bankruptcy, the contractual terms in the firm's contracts with these creditors would become required terms in the firm's contracts with the remaining creditors. Hence, the firm's credit contracts would be consistent.

inefficient. To see why, realize first that the trade creditors could have a minority in amount of the debt that existed at bankruptcy but incur losses from the firm's relatively rapid disappearance in procedure *L* that would outweigh the financial creditors' gains. The financial creditors would ignore these losses to vote for the renegotiation-proof contract. The firm would contract out of this inefficiency, however, by refusing to offer any creditor a renegotiation-proof contract. The worse ex ante deals the firm would get from its financial creditors without the contract would be more than outweighed by the better deals the firm would get from its trade creditors. When the trade creditors held a majority in amount of the debt, its dissent sometimes would kill a bankruptcy contract in favor of a contract that imposed losses on the financial creditors in excess of gains to the trade creditors. The trade, like the financial, creditors would not consider these losses when making its decision. Again, however, the firm could obtain sufficiently good terms from the financial creditors by offering the optimal bankruptcy contract to permit the firm to induce the trade creditors to sign also. As a consequence, majority rule contracts would be efficient either automatically or because of the firm's actions.

## II. THE IRRELEVANCE OF CURRENT BANKRUPTCY CONTRACTING

Professor LoPucki devotes more than a third of his reply to an argument that sophisticated parties today contract about bankruptcy with the primary object of redistributing wealth to themselves from involuntary and nonadjusting creditors.[29] This argument seems meant to show that society would not benefit even if ex ante bankruptcy contracting were permitted and did occur. Professor LoPucki primarily discusses securitization and ex post stay waivers, and he infers from these and other current contracting practices that the "real-world appeal of bankruptcy contracts lies less in their capacity to maximize social welfare than in their capacity to redistribute wealth."[30] This leads to Professor LoPucki's conclusion that ex ante bankruptcy contracts that fail to have the actual assent of every creditor, voluntary and involuntary, "may be both redistributional and inefficient."[31]

This conclusion cannot rest on the contractual practices that Professor LoPucki criticizes here. In understanding why, begin with involuntary creditors. Securitization, stay waivers, and the other contracts Professor LoPucki discusses attempt to remove the firm from bankruptcy jurisdiction

29. This view is controversial. *Compare* Lynn M. LoPucki, *The Death of Liability*, 106 YALE L.J. 1 (1996), *with* James J. White, *Corporate Judgment Proofing: A Response to Lynn LoPucki's* The Death of Liability, 107 YALE L.J. 1363 (1998).

30. LoPucki, *supra* note 4, at 339.

31. *Id.* at 342.

altogether. If the contracts succeed in this, then rules that protect involuntary creditors in bankruptcy may be ineffectual. The contracts I discuss, in contrast, would permit the parties to choose among state-supplied bankruptcy systems. If the state, for example, were to give tort claimants an administrative priority in all of its bankruptcy systems, the general creditors in my world would take behind these claimants, for the general creditors would be *in* a bankruptcy system. Thus, permitting bankruptcy contracting would not remove involuntary creditors from the protection of bankruptcy law.

Professor LoPucki's reference to the exploitation of nonadjusting creditors also is not germane. In commercial law scholarship, a nonadjusting creditor will not alter the interest rate (or other terms) to reflect its actual priority position. For example, other things being equal, a creditor should charge a higher interest rate when it would take behind a secured creditor than when it would take pro rata with that creditor. A nonadjusting creditor, however, will charge the lower pro rata interest rate either because it is unsophisticated or because the costs of altering its contracts deal by deal would be too high in relation to the gains. Nonadjusting creditors thus are disadvantaged by their contracts with the firm.[32]

Bankruptcy contracts could not disadvantage creditors just because they were unsophisticated or did not find it cost-justified to focus on bankruptcy contracts. The firm in my model offers a bankruptcy contract to every creditor. Creditors who pay attention will sign the optimal contract with respect to bankruptcy. This contract would induce the firm to choose the bankruptcy procedure that would maximize the ex post value of the firm, and this would benefit the nonsigners. Therefore, while there can be nonsigning creditors in the world I model, there seldom will be nonadjusting creditors—a subset of creditors who would have rejected the firm's contract had they paid attention. To summarize, it is a non sequitur to infer from current contracting practices about bankruptcy that the ex ante bankruptcy contracts I describe would be redistributional rather than efficient. Rather, this must be shown by an analysis of the contracts themselves.

32. For analyses of nonadjusting creditors, see Lucian Ayre Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857 (1996); and Ronald J. Mann, *The First Shall Be Last: A Contextual Argument for Abandoning Temporal Rules of Lien Priority*, 75 TEX. L. REV. 11 (1996). An argument that the case for the exploitation of relatively small creditors is poorly grounded is made in Alan Schwartz, *Priority Contracts and Priority in Bankruptcy*, 82 CORNELL L. REV. 1396, 1414-17 (1997).

## III. CONCLUSION

The differences between Professor LoPucki and me lie in the realm of analysis, not in the realm of opinion. Professor LoPucki proposed a contracting practice that would unravel the sequential bankruptcy contracts I developed. Such a practice is fraudulent, and my model assumed the absence of fraud. *Therefore*, Professor LoPucki's practice would not unravel these contracts. Professor LoPucki developed an example to show that junior/senior conflict over bankruptcy procedures would disrupt any bankruptcy contracting scheme. This example follows only if courts do not observe absolute priority, but my model assumed that courts would observe absolute priority. *Therefore*, Professor LoPucki has not shown that junior/senior conflict would disrupt bankruptcy contracting.[33] Professor LoPucki argues that trade/financial creditor conflict also is pervasive and would preclude much bankruptcy contracting. His argument presupposes a legal world in which the preferences of a majority in amount of creditor claims would not determine whether a bankruptcy contract became effective. My model assumed that majority preferences would control, and when they do, trade/financial creditor conflict would be overcome. *Therefore*, this conflict would not preclude bankruptcy contracting. Professor LoPucki acknowledges that if creditors could deal with each other, they could write contracts that would overcome many of the conflicts he thinks they face, but the creditors do not deal with each other. The borrowing firm, however, deals with all of the creditors and so could coordinate contracting among them. *Therefore*, contracting among the parties would cure many of the difficulties Professor LoPucki believes would otherwise exist. Drawing upon current contracting practices that attempt to avoid bankruptcy altogether, Professor LoPucki infers that ex ante bankruptcy contracts also would deprive some claimants of the law's deserved protection. The bankruptcy contracts I discuss would permit the parties to choose a bankruptcy procedure, not to avoid bankruptcy. *Therefore*, Professor LoPucki's inference fails. We are thus left where my essay ended—with a plausible case for expanding the scope of free contracting in bankruptcy.

The lengthy treatment in Professor LoPucki's essay of commercial practices that have nothing to do with ex ante bankruptcy contracts suggests that he is suspicious of all contractual schemes that deal with bankruptcy. This suspicion appears most clearly in his note 114, where he remarks that it is hard to know how often parties today avoid the current bankruptcy

33. This Response also shows that junior/senior conflict would be rare even if courts did not follow absolute priority.

system because successful attempts necessarily are invisible to outside observers. He says of this:

> Secrecy may provide an important reason for society to reject contract solutions. The problems with regulation occur publicly and are therefore subject to examination and correction through the political process. The problems with contract occur privately and can be examined only to the extent that contracting parties volunteer information or the state requires disclosure. The latter is unlikely to occur unless some question is first raised regarding the particular type of contracting.[34]

This view implies that every commercial contract that could affect a third party should be approved by a regulator as a condition to its becoming effective. Otherwise, "the problems with" these contracts would "occur privately." [35]

Professor LoPucki probably would not advocate the creation of a federal Agency of Contractual Justice to regulate the tens of millions of contacts a year that could create externalities or that might be unfair. Rather, he seems to think that bankruptcy is special; hence, contracting about bankruptcy should be specially regulated. Professor LoPucki thus appears to be what Douglas Baird recently called a traditionalist about bankruptcy—a person who thinks that the state should regulate bankruptcy with laws whose animating rationales are (and ought to be) rejected everywhere else.[36] Professor Baird challenged the traditionalists to say why bankruptcy is special in this way. Professor LoPucki's essay here may be a prologue to such an explanation but it is too brief to be the explanation itself.

34. LoPucki, *supra* note 4, at 336 n.114.

35. Professor LoPucki also claims that the "principal problem in attempting to apply" a contracting theory to bankruptcy "is that most creditors' interests are too small to warrant their active, knowledgeable participation" in a bankruptcy procedure. *Id.* at 341. A bankruptcy contract governs the state of the world in which the firm's transactions have failed. Hence, Professor LoPucki's view applies to commercial contracting generally; for many terms in commercial contracts concern what should be done if the deal goes bad. If "most" parties have too little at stake "to warrant their active, knowledgeable participation" in the legal worlds these terms create, then a large portion of commercial contracts should be regulated to ensure their fairness.

36. *See* Douglas G. Baird, *Bankruptcy's Uncontested Axioms*, 108 YALE L.J. 573 (1999).